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The American
Antitrust Institute

TESTIMONY

OF

ALBERT A. FOER

ON BEHALF OF

THE AMERICAN ANTITRUST INSTITUTE

Concerning Airline Mergers

BEFORE THE

COMMERCE, SCIENCE AND TRANSPORTATION COMMITTEE

UNITED STATES SENATE

JUNE 21, 2000

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Mr. Chairman and Members of the Committee:

Thank you for this opportunity to present this statement on behalf of the American Antitrust Institute regarding the proposed acquisition of USAirways by United Airlines. I am Albert A. Foer, President of the American Antitrust Institute.The American Antitrust Institute is an independent non-profit education, research and advocacy organization. We are generally centrist and pro-competition in orientation and operate with the assistance of an advisory board composed of many of the leaders of the antitrust community, including academicians and practitioners in the fields of law, economics, and business.

It is always difficult for an outsider to comment on the impact of a particular merger. The Department of Justice, investigating whether the proposed acquisition of US Airways by United Airlines violates Section 7 of the Clayton Act, will have the advantage of proprietary information, strategic planning documents, commentary of industry experts, and detailed economic analysis to which we are not privy. Nevertheless, a transaction of this size, creating a single airline with over one-quarter of the national market and a dramatically larger share for many city pairs, naturally raises a variety of questions for consumers of air transportation. We will focus on three questions: How well is airline competition working currently? What effect will this merger have on competition and consumers? And is there a viable remedy short of blocking the merger?

1. How well is airline competition working currently?

The deregulation of air transportation that has occurred since 1978 has had mixed results. On the one hand, prices are relatively low for many routes and consumers are flying far more than they were in 1978. On the other hand, for city pairs where there is little, if any, competition, rates are inordinately high. Consumers often report that they do not feel very sovereign. The airlines have mastered the art of price discrimination, in an attempt to charge each customer the highest price that customer

is willing to pay. Ironically, this price is called, in economics, the consumer's "reservation price". Price discrimination is only possible where there is market power and the unusually large role that price discrimination plays in air transportation reflects that the airlines do have a high degree of market power.

Where does this market power come from? On a national level, there are three dominant airlines of approximate parity (United, American, and Delta) but there are additional major players like US Airways, Northwestern, and Continental, which bring real competition to certain regions and routes. In addition, Southwestern has a significant impact as the low price maverick in those markets where it has a presence, and a modest number of small carriers also provide the consumer with a degree of choice. From this industrial structure alone, one might anticipate that the market would be performing in a reasonably competitive manner. But one must also look at several other factors, which may work to reduce the intensity of rivalry.

These include:

a) A system of alliances that may enhance the seamlessness of travel for many consumers but may also undermine the degree of competitive threat that an airline represents in regard to its allies. On the latter interpretation, we have only three truly separate major air systems.

b) A hub-and-spoke system that in conjunction with practices which are either aggressively competitive or illegally exclusionary efforts to maintain hub monopolies, depending on your perspective, eliminate most competition from most hubs and permit prices at such hubs to rise to high levels.

c) Other collaborative practices, such as the T-2 joint venture now being constructed by the major airlines for the purpose of either enhancing efficiency in the marketing of airplane seats or for destroying independent ticket agencies and electronic alternatives, again depending on your perspective.

Each of these features of the airline market has either been subjected to investigation by the Justice Department or is currently under scrutiny, as is the partial

acquisition of Continental by Northwest. You can tell the story in two different ways: either we have a competitively structured air system that is continually finding new ways to enhance efficiency and better serve consumers; or we have a system that is in reality far less competitive than it appears to be.

If the former view is correct, then a merger of the 1st and the 6th airlines might not be terribly threatening to competition. If the latter view is correct, then this merger can only make a bad situation worse.

My own view is that the industry is somewhere in between, closer to the pessimistic end of the spectrum. In this case, we need to ask additional questions.

2. What effect will this merger have on the industry and on consumers?

The Clayton Act is an incipiency statute. The Congressional intent was for the law to stop mergers whose effect substantially "may" be to lessen competition. Congress did not want law enforcement to wait until the damage has already been done and it did not want a standard of absolute certainty. Congress understood that prediction is inherent in the process of merger evaluation.

The Clayton Act invites the Antitrust Division to take into account all of the likely effects of a merger. For example, if the United/US Airways deal were likely to trigger additional deals, it would be relevant to the determination of whether the United acquisition should be permitted. Recall that United, Delta, and American are currently more or less equals. News reports strongly suggest that American and Delta are already investigating mergers, both with others and with each other, in response to the dramatic expansion of United that will be accomplished if the merger is permitted. If American and Delta believe that they must maintain some rough size parity in order to maintain competitive parity, then additional mergers are reasonably likely. This presents a difficult problem for the Antitrust Division. It should not stop the United merger based on mere speculation about the future; but it should not close its eyes to reasonably strong evidence

that other mergers will quickly follow. The confounding fact is, to let the merger go through represents as much a prediction as a decision to stop it.

The impact of this merger on consumers will depend on many factors. Those most immediately at risk, of course, are those dependent on airports that are currently served by both United and US Airways and who will find themselves deprived of one of what had already been a limited number of choices. Choice is what competition is all about. Price is often a workable proxy for choice, but even if it were taken off the table in this transaction through a meaningful promise not to raise prices, consumers would still be impacted in a negative way by the reduction of options. Why is it that when an airplane lands and taxies toward the terminal, the steward or stewardess so often says, "Thank you for flying with ABC Airline. We know you have a choice and we want you to choose us again next time you fly." I think this is a recognition by the airline that consumers are aware that in fact they really have few choices, but that choice is important to them. If we were to go from six major airlines to five, an important element of choice would be lost. But how often does a given consumer booking a given trip actually have six airlines to choose among? And if this merger triggers others, how much choice will be lost?

My point is that Justice cannot hide from the need to make predictions. It must collect as much information as possible that will help it to make the best predictions it can and then it must boldly make a judgment. Some of its information will not be public and cannot be made public, but the public will be owed an explanation of what prediction Justice ultimately relied upon and the reasoning by which Justice reached its judgment.

3. Is there a viable remedy short of blocking the merger?

Most mergers today are either permitted to be consummated or are conditionally approved, subject to the divestiture of overlapping assets. It is reported that United has proposed two concessions in order to take antitrust issues off the table. First, it will hold prices in place for two years. Second, it will spin off certain assets at Reagan National Airport in order to create a new regional carrier to be based there.

Before asking questions about these proposed concessions, it is necessary to put the matter in perspective. The Clayton Act is violated whenever competition may be substantially lessened in any line of commerce or in any geographic market. If there is one geographic market where the illegal effect may occur, the merger is technically illegal. Now, the agencies don't act on this severe interpretation because it would be wasteful of everyone's resources. If there were a minor overlap in one small market, and the whole merger were blocked, this would be easy to fix by selling off an offending asset and starting the merger all over again. To avoid this inefficient process, the antitrust agencies routinely negotiate with merging parties to fix the identified problem areas, without sending the parties back to square one. The agencies have substantial bargaining power, however, since they do have the right to go to court to stop a merger. They must use this power to keep the merger from the likelihood that its consummation will lessen competition. This is the standard against which United's proposals should be measured.

With respect to the two-year moratorium on price increases, the Justice Department should be skeptical. The merger, like a diamond, may be forever. If this merger makes it possible for United to raise prices in year three, as a result of increased market power, then it should be blocked and the two-year concession rejected. If there is not a likelihood of a price increase, one wonders why United raised the issue?

But in an industry where price discrimination is so sophisticated and widespread, it is also necessary to ask, what is meant by a price freeze? The mix of seats sold at different prices changes daily, sometimes hourly. To hold one seat at a low price while selling many more at a higher price, albeit no higher than the current highest price, would be a gimmick of no substantive value to consumers.

What about spinning off assets to a new airline that can fly in and out of Reagan National? The relevant questions appear to be: (a) will this new airline have enough assets to survive? (b) will the assets be sufficiently independent of United so that they can be used in direct competition against United? (c) will the assets include enough valuable routes so that the carrier can survive? (d) will the carrier have sufficiently competent and

air-expert management to survive in a market place that will probably quickly come to include more competition from low-price Southwestern and from new regional jets? Or, put another way, from the viewpoint of the consumer, will this start-up realistically be able to step into US Airways' much larger shoes?

This question in itself subsumes another: what would be the fate of US Airways in the absence of this merger? Clearly, it has not always flown in calm skies and there has been speculation about its future. Justice will again have to make a prediction and the public will again be entitled to an explanation of the prediction. If US Airways in effect has no future, antitrust policy will have less reason to seek the continuity of its franchise. This is not to suggest the presence of a "failing company" defense, which is well-recognized in the antitrust law but is apparently not being claimed here. It is, rather, to say that the evaluation of a remedy must take into account the role that US Airways would likely have played, against which can be compared the de facto substitute player or players expected to replace US Airways.

Indeed, if there is good reason to believe that US Airways could have remained independent and healthy, one can ask whether US Airways might have been one of a small number of potential competitors that could enter the concentrated markets of other large carriers. It may have an impact on competition as a potential competitor, and if so, it is doubtful that a smaller newcomer will be able to play a similar role for many years. Conversely, United claims that it needs to expand into the northeast so that it can better serve consumers. This may establish United as an important potential entrant whose ability to enter from outside, without a merger, plays a role that should not be easily dismissed.

There is a final question we would pose: if the merger is to be allowed to go through, what are the best means for assuring that divestitures result in no loss of competition? Is it by allowing United to spin off selected assets to a hand-chosen competitor? Is it by auction of slots? And of course this question must be asked with regard to each route in which there the merger will raise concentration to unhealthy levels.

Conclusion

Determining whether this merger is legal or how it can be made legal through various conditions that might be imposed, requires the Justice Department to undertake a detailed evaluation of facts and to make sophisticated predictions. A thorough analysis, in our opinion, requires consideration of US Airways' ability to survive as a competitive airline, its role as a potential competitor, United's role as a potential competitor, and the likelihood that this merger will trigger additional mergers. Ultimately, what is required is a vision of how concentrated we will allow the market for domestic air transportation to become. This can be established in the course of antitrust analysis or it can become established by specific act of Congress. But once an industry becomes as concentrated as air transportation, it makes no sense to treat each merger on an ad hoc basis without a larger vision of where we are headed.